1963

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Recommended Citation
Haskins & Sells Selected Papers, 1963, p. 218-231

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Presented before the Haskins & Sells Annual Tax Conference, Chicago—October 1963

Before we get into the taxation of banks let's take a brief look at the industry. Banking has been undergoing a dynamic change. Since World War II there have been two significant trends in banking. The first has been the increasing competition from other financial institutions. Federal savings and loan associations, mutual savings banks, and credit unions have experienced a more rapid growth in deposits as compared with the growth of time and saving deposits of commercial banks. This in itself is interesting because commercial banks have been aggressively competing for savings accounts.

The second trend has been the increase, proportionately, of savings accounts. In 1946 time and savings deposits accounted for only about 24 per cent of total commercial deposits; today they are over 40 per cent of total deposits. During the past eight years savings and time deposits of commercial banks increased by 118 per cent while demand deposits rose only 15 per cent.

This change has had a dramatic effect on banking. The cost of time deposits has increased operating costs tremendously and has caused banks to shift to higher-yielding loans and investments. Indicative of the need for higher-risk and higher-yield investments is a relaxation of restrictions on real estate loans by national banks. Presently, banks can lend money on improved real estate up to 75 per cent of value and for periods of up to 20 years. Formerly, banks were limited to two-thirds of value and periods of up to ten years. This limit was susceptible to some maneuvering because a loan could provide a balloon payment at maturity provided that 40 per cent of the original loan had been amortized.

These trends have probably contributed to the increase in mergers and also to an increase in the establishment of branches in those states where branch banking is permitted.

We also have an extremely aggressive Comptroller of the Currency. Two of his recommendations have been particularly disturbing to the banking fraternity: one, that a national bank should be able to establish branch banks irrespective of State law; and the other, that banking supervision be concentrated in the hands of the Comptroller.

These changing trends in banking may alter the tax viewpoint of many bank officials and create tax problems in areas not previously significant insofar as commercial banks are concerned.

Commercial banks are subject to the usual corporate tax law, but because banking has certain special characteristics a number of laws have been passed to fit their operations. The character and general conservatism of many bankers can likewise be a factor in tax planning and tax consultation with banking officials.

In our discussion today we shall first review the special areas in which banks are singled out for special, favored treatment either by law or by administrative practice. The remainder of the time will be devoted to consideration of general tax planning in problem areas, with emphasis on those areas that seem to apply particularly to banks.

SECURITY TRANSACTIONS

One of the special characteristics of the taxation of banks concerns security gains and losses. Under the rules governing security transactions, banks have an extraordinary opportunity to trade ordinary losses for capital gains. Banks are required to hold sizeable amounts of securities to maintain liquidity. Bonds held by banks, other than as security dealers, are capital assets, and capital gain is realized upon the sale or exchange of such assets. However, for a bank, if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certficates, or other evidence of indebtedness issued by any corporation (or by a government or political subdivision thereof) exceed the gain of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset. Thus, losses in excess of gains are deductible as ordinary losses, but if gains exceed losses, they are taxed at capital gain rates.

The original 1954 Code limited banks' ordinary loss on sale of corporate or government bonds or other evidence of indebtedness to bonds, notes, etc., that had interest coupons attached or were in registered form. The Technical Amendments Act of 1958 deleted this requirement, so that effective retroactively for all '54 Code years corporate and government obligations no longer need have interest coupons attached or be in registered form in order to qualify for the ordinary loss treatment.

For bonds, debentures, notes, or certificates or other evidence of indebtedness that are capital assets in the hands of the taxpayer and are issued by any corporation, or government or political sub-division thereof, amounts received by the holder on retirement of such bonds or other evidence of indebtedness shall be considered as amounts received in exchange therefor. If such evidences of indebtedness have been issued before January 1, 1955, this provision applies only to those issued with coupons or in registered form, or to those already in such form on March 1, 1954.

With proper planning, several tax-saving measures may be derived from these provisions. A bank may take advantage of the capital gain-ordinary loss interplay by realizing losses in one year and taking capital gains in the succeeding year. In addition, a bank may sell a bond that has suffered a price decline, purchase another depressed bond not substantially identical to the first, and thus take an ordinary loss in preparation for a future capital gain. The "Wash Sales" rule applies to banks and would disallow the loss deduction if the bonds purchased were substantially identical. Whether the replacement securities are "substantially identical" is a question of fact. If it is desirable to repurchase the identical securities, thirty-one days must elapse either before or after the sale before consummating a repurchase, if the loss is to be recognized.

Banks are subject to the amortization of bond premium rules the same as any other taxpayer. For the purpose of the amortization rules, the term *bond* means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political sub-division thereof), but does not include any such obligation constituting stock in trade of the taxpayer or any such obligation of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Generally, the amortizable bond premium is the excess of the basis of the bond over the amount payable on maturity or earlier call date. However, there are two exceptions to this general rule.

The premium on all taxable callable bonds acquired after 1957 (regardless of date of issue) may not be amortized to any date before maturity unless a smaller deduction results from amortization to an earlier call date. If a smaller deduction results, the earlier call date must be used.

If a bond, the interest on which is wholly taxable, is acquired after January 22, 1954 but before January 1, 1958, and was issued after January 22, 1951, and has a call date not more than three years after the date of such issue, amortization is to be taken with reference to the amount payable at maturity only. These two exceptions were added to the Code by the Technical Amendments Act of 1958 to prevent rapid amortization written off against ordinary income with a subsequent sale at a gain which would be taxed at capital gain rates.

With respect to fully tax-exempt bonds and partially tax-exempt bonds, amortization of premium is mandatory. With respect to fully taxable bonds, amortization of bond premium is optional, at the election of the taxpayer. Generally, a bank should elect to amortize the premium on fully taxable bonds because ordinary amortization deductions result.

If such an election is made with respect to any bond of the taxpayer it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him, and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, on application by the taxpayer, the Secretary or his delegate permits him, subject to such conditions as the Secretary or delegate deems necessary, to revoke such election.

With a fully taxable bond the amortizable premium is applied both as an adjustment to the basis of the bond and as a deduction in computing taxable income. Amortizable bond premium of a fully tax-exempt bond is an adjustment to the basis of the bond only. On partially tax-exempt bonds, the amortizable bond premium adjusts the basis of the bond, reduces the amount of interest subject to tax, and reduces the section 242 deduction with respect to the interest. Section 242 allows a corporation a deduction for the amount received as interest on obligations of the United States or on obligations of corporations organized under Act of Congress which are instrumentalities of the United States if such interest is included in gross income and such interest is exempt from normal tax under the Act authorizing the issuance of such obligations.

The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year. For bonds which have call dates, and to which either of the two exceptions relating to limited amortization in the case of call dates applies, a deduction against ordinary income is allowed in the year the bond is called.

The Code gives a bond holder some latitude in determining the amount of amortization. Determination of amortizable bond premium shall be made in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable. Unless the taxpayer regularly uses some other reasonable method, he must use the Commissioner's method.

If a bank has held an appreciated bond for over six months, the bond could be sold and a capital gain realized. Since wash sales do not apply to gains, the same kind of bond may be repurchased and amortization deductions may be taken for the replacement bond. Thus a tax savings would result from trading the ordinary amortization deduction for long-term capital gains.

TAX-EXEMPT SECURITIES

Investing in tax-exempt or partially tax-exempt securities offers important tax savings possibilities for banks. As a general rule, if a taxpayer incurs a debt in order to purchase or to carry wholly tax-exempt securities, the interest deduction is disallowed. However, this provision has no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business, since such indebtedness is not considered to be indebtedness incurred or continued to purchase or carry obligations. The Treasury Department is alarmed, I understand, at banks' participation in alleged abuses of municipal bond tax exemptions. Suppose a municipality has an outstanding bond issue callable in ten years. It decides to refund in advance because it believes interest rates are favorable now. It issues bonds at an interest cost of, say, 3 per cent and invests the proceeds of the issue in U. S. Treasury bonds yielding approximately 4 per cent. The municipality has a net profit of 1 per cent on a pure investment. Apparently some banks have participated with municipalities in this manner. The municipality sells bonds to a bank and leaves the proceeds as a time deposit, again at approximately 4 per cent. While the bank is paying 4 per cent interest and receiving only 3 per cent on the municipal bonds, because the interest paid is tax deductible, there is a net after-tax gain to the bank of approximately ½ of 1 per cent, plus the use of the money on deposit. The rapid spread of these devises, as word gets around among municipalities, may lead the Treasury Department to request legislation.

RESERVE FOR BAD DEBTS

Banks have the usual option available to taxpayers generally of being on either the reserve or the specific charge-off method of accounting for bad debts. Banks do have an advantage over other taxpayers in that the Treasury has provided a definitive method that banks can use in determining the annual addition to the reserve for bad debts—the Treasury's famous Mimeo 6209, as supplemented by various rulings.

Under these pronouncements a bank can determine its annual addition on the basis of using a 20-year moving average of its bad-debt experience, or it can use the experience record of any 20 consecutive years after 1927 in determining the annual addition to the reserve. The advantage of the fixed period is that a bank can determine its bad-debt reserve based on its experience during the depression years. Under the moving average the depression years would now be completely eliminated from the bank's experience.

In determining the factor or percentage to be applied to the loans outstanding to determine the annual provision, banks are given a further choice:

1) The factor or percentage is the ratio of the total bad-debt losses to total loans outstanding for the entire 20-year period. For example, suppose a bank had \$1,000,000 loans outstanding at the end of each of the 20 years, or a total of \$20,000,000, and its actual bad-debt losses (provisions less recoveries for the 20 years) were \$200,000; then the applicable factor would be 1 per cent.
2) The factor or percentage is the average of the total percentage for the 20-year period, determined on an annual basis.

Once an election is made to use either method the bank must follow it consistently.

If a bank is using the fixed 20-year period, the average of the total percentages would generally appear to produce a greater deduction. This is so because the depression years, with larger bad-debt losses and smaller loans outstanding, would be given the same weight as a later year with presumably smaller bad-debt losses and greater loans outstanding because of bank expansion and the effects of inflation.

The factor applied to the loans outstanding will constitute the minimum reserve. Each year's allowance for bad debts may be at least as much as is necessary to bring the reserve up to the minimum. The maximum reserve is limited to three times the rate established.

A bank using this method of computation is not required to add the allowable amount to its reserve, but may add a smaller amount. This choice adds flexibility and could be important to a bank that had just commenced operations.

The formula is to be computed on loans comparable in nature and risk to those the bank has presently outstanding. The Treasury has stated that this is intended to cover special situations and is not intended as a barrier prohibiting or curtailing unduly the use of the formula.

Guaranteed loans are to be excluded from these computations. Originally this applied only to wholly government-insured or government-guaranteed loans. Presently it applies to any loans to the extent that they are guaranteed or insured by the government. Certificates of interest issued by the Commodity Credit Corporation and Title II FHA loans are considered to be fully guaranteed for these purposes.

If we have banks that are presently on the specific charge-off method, we should consider the desirability of requesting permission to change to the reserve method. While banks may have less trouble with the specific charge-off method than other taxpayers because debts ordered written off by regulatory authorities are presumptively worthless, the advantages of the reserve method can likewise be greater for banks because of the greater assurance they have that their reserve will not be challenged so long as they follow the ground rules in the pronouncements.

A new bank or a recently established bank can utilize other banks' experience. While it may be difficult to determine the bad-debt experience of a comparable bank, the data compiled by the Federal Reserve Board relating to the experience of member banks in its own district should be acceptable. To the extent of the period that a bank has been in existence, it is required to use its own experience.

Some tax writers and tax publications have taken the position or at least have implied that a bank's bad-debt deduction would not be disturbed so long as it followed the rules in computing the addition. This is not so. This mechanical formula does not have the force and effect of law. In the Trust National Bank at Wilkinsburg, the taxpayer was successful in his contention that the bank's reserve was not limited to the formula.

On the other hand, we have a recent case, Central Bank Company (39 TC 90), where the Commissioner had disallowed deductions of $35,000, $30,000 and $30,000 taken by Central Bank as additions to its reserve for bad debts for the years 1956-1958. The Commissioner contended that the taxpayer had misapplied the formula, or in the alternative, if the taxpayer did not misapply the formula, failed to prove that the disallowances of the additions was an abuse of the discretion vested in the Commissioner by section 166(C).

The Tax Court sustained the Commissioner and refused to narrow the question of whether Mimeo 6209 had been properly applied. The ultimate issue was the correctness of the disallowance under section 166. The force of the Mimeo and subsequent rulings as stated by one of the judges in a concurring opinion "was to provide taxpayers with a formula for determining reasonable additions to reserves; and not to authorize an already adequate reserve to be increased to a point where it would become excessive." This case is presently on appeal to the 6th Circuit.

The Service, in response to numerous inquiries following this case, announced in TIR-499 that it would continue to allow additions to bank bad-debt reserves when the additions are properly computed.

In those cases where the reserve is excessive the formula doesn't offer any real comfort. In line with its pronouncement the Treasury can almost always find grounds for alleging that the formula has been misapplied; moreover, the courts would apparently support the position because the additions to the reserve are unreasonable.

ACCOUNTING METHODS OF BANKS

Since banks must respond to the supervision of State and Federal banking officials and at the same time must fulfill the requirement regarding the reporting of income, there may be some difficulty in ascertaining when income is realized for income tax purposes by banks.

Although accounting methods generally make use of either the accrual basis or the cash basis, banks as well as other taxpayers often employ combinations of the two and variations of each. For tax purposes, however, a bank must report either on the cash basis or on the accrual basis. Where hybrid methods are used, even though incorrect, consent must be obtained from the Commissioner before a change can be made.

Commissions and discount are two items that are more common to banks than to other corporate taxpayers.

Under the cash method of accounting, commissions are income when and to the extent they are actually received. If a bank reports its income on the accrual basis, commissions on loans are income in the year in which the loan is made.

Discounts, like commissions, are commonly deducted from the face amount of the loan at the time it is made and is the amount charged by a bank as interest on a loan. If the cash basis is used, discount on single-pay notes is income to the bank when the note is paid. If the note is payable in instalments, the discount is reported as income ratably over the period of the loan. Under the accrual method, discount is income to the bank in each tax year that the discount is earned.

A bank served by us reports on the cash basis and does not have a reserve for bad debts. A few years ago, this bank was reporting income from bank discounts on non-interest-bearing notes payable in instalments when the loan was made. Permission was received to change from this incorrect method to the method of reporting the discount as income, ratably over the period of the loan. At that time, the cut-off method was permitted and the bank was not required again to report unearned discount which had previously been reported with a corresponding deduction for the duplicated income spread over a ten-year period.

Another office prepares income tax returns for a cash-basis bank that formerly reported income from bank discount on instalment loans only when the loan had been paid in full. Payments received on instalment loans were credited to an account called "Hypothecated Deposits." When a loan was paid in full, the Hypothecated Deposit account was debited, with a credit to the consumer credit loan account, and deferred income was transferred to an income account.

The bank's returns were examined by the Internal Revenue Service and the Agent attempted to make a change, holding that such a change was a correction rather than a change in method of accounting. Technical advice was requested from the National Office, which eventually ruled it a change in accounting method initiated by the Service. On the rollback, the bank picked up some tax-free income.

ACQUISITIONS AND MERGERS

An area of intense interest to banks and bankers is the acquisition of other banks. Although during the past seventeen years there has been a net decline in the number of banks—there are in fact 779 fewer banks—there has been a tremendous increase in the number of branch banks—about 8,400. In connection with acquisitions there are two points of interest to banks. First, national banks are prohibited by law from owning common stock in other domestic corporations. This has the effect of limiting the manner in which new companies are acquired. In our section of the country, most acquisitions have been made either through outright purchase or via the merger route.

The other factor is that any merger or combination of national banks must be approved by the Comptroller of the Currency. The Federal Reserve Board passes on mergers of State member banks and the FDIC for nonmember insured banks. The law requires that in each case the authorized agency must seek and consider the opinions of the other two agencies before making a final decision, and they must also have received the views of the Department of Justice on the competitive aspects of the merger.

Judging from the performance of the present Comptroller, James Saxon, most national banks seeking to merge should experience little difficulty in obtaining approval. Mr. Saxon's record for the first seventeen months he has been in office—spanning the period November 1961 to April 1963—includes approval of 140 out of a total of 147 applications. These actions were taken despite the fact that the advisory reports he received from the other agencies respecting the effects that the mergers would have on competition were adverse many times. The Justice Department objected to 87 of the mergers, the Federal Reserve to 79, and the FDIC to 42. All three agencies objected to 26 of the mergers.

Another important development in the merger or combination area as it pertains to banks was the recent U.S. Supreme Court decision holding that the proposed merger of the Philadelphia National with the Girard Trust Corn Exchange was in violation of the Clayton Act. Formerly, banks had considered themselves immune from the Clayton Act.

What about tax considerations that may be of particular interest to banks? Except for the approach in making the acquisition, the general rules are applicable to banks. In an outright purchase there are two considerations that could have a particular bearing, certainly as they apply to negotiations for a sale. Assuming that the selling bank is liquidating, it would logically follow that the liquidation would come under the provisions of section 337, which could result in the selling corporation's having a substantial amount of income being recognized. Assuming the loans are sold at face value, the reserve for bad debts will have to be restored to income. Also, if the selling corporation is on a cash basis, interest earned on loans to the date of sale would be required to be reported in taxable income.

The selling bank would probably have been planning this move for some time, and might very well have arranged the sale to take place shortly after the end of its fiscal year. In the final year of banking operation it might spruce up its portfolio by recognizing all losses —fully deductible against ordinary income—and retain its gain securities for sale in the liquidation period. Claiming these losses in the final year of regular operation is subject to attack, but if the one-year period of liquidation encompasses the period in which the loss securities were sold, section 337 would still apply to the liquidation.

In a merger there is one problem equally applicable to corporations other than banks, but it may be a good deal less important to them. Two banks may have the same over-all accounting method, but each may have a different accounting method for a number of material items, such as discounts. The principal method of accounting will probably govern, but bringing them into agreement could require a change of accounting method for one of the banks and result in a substantial tax liability.

For some banks a divisive reorganization may be good tax planning. It would appear that a tax-free spin-off could be effected where a bank operates a rental building and occupies only a minor part of it. One of the examples in the regulations illustrates that two separate trades or businesses are being carried on where a bank owns an eleven-story building and conducts its banking business on the main floor. The operation of the bank constitutes a business as does the operation of the rental property.

DEPRECIATION AND THE INVESTMENT CREDIT

Banks may not have many unusual problems in the depreciation area, but some of them at least have tended to minimize the importance of depreciation. The fixed assets required in banking operations have been relatively minor in comparison with their other assets. In many instances the bank's operating real estate has been written down to a nominal amount as the property tended to assume less importance in the eyes of the bank's officials.

A recent discussion with the controller of a bank related to the use of Guideline depreciation and whether the bank would be adopting Guidelines lives. It was indicated that this matter had been considered and that, while Guideline lives would give considerably greater depreciation allowances, it had been concluded that the bank should continue its prior schedule of individual lives for the various classes of assets. Working capital wasn't too important an item as far as the particular bank was concerned. It was admitted that greater depreciation allowances would give a greater loan base.

Another bank has always maintained excellent physical inventory control of its fixed assets, but this control was not integrated with the accounting records. The bank had also followed the policy of removing all fully depreciated assets from the accounts. Now it is encountering tremendous difficulty in arriving at the fixed assets actually in use in order to determine the effect of adopting Guideline lives.

The adoption of Guideline lives should offer a good deal to banks as it does to other taxpayers. Many banks have changed or are in the process of changing to an electronic data processing system with consequent heavy expenditures in equipment. This in itself could be enough to justify serious consideration of adopting the Guideline lives. The advantages of simplified depreciation accounting can likewise be attractive.

A matter that may be troublesome to banks in the investment credit area is the appropriate manner in which to treat bank vaults. Banks have traditionally treated bank vaults as a building component. With the possibility of obtaining the investment credit, the bank would prefer to consider it as tangible property other than buildings.

It seems to me that the bank would be on fairly solid ground if it treated the vault proper as a part of the building, but the vault door as being subject to the credit. Some banks in entering into leases have in the past followed a policy of specifying that the vault belonged to the bank, and if the premises were vacated, the bank would have the right to remove the vault door. Any bank that has such a policy in force should be in a good position to argue that it is entitled to the credit.

DEMOLITION LOSSES

The rules in regard to demolition losses are the same for banks as for any other taxpayer. Where land and buildings are purchased with the intent either to replace or to demolish existing structure, no loss is allowed, since the entire cost is considered cost of the land. Where a building is demolished subsequent to acquisition with the intention to erect a new one, there is conflict as to whether the unrecovered cost of the old building is deductible as a loss, or whether it is added to the cost of the new building.

With increased emphasis on branch banking, new quarters are needed, and often expensive property is acquired with the intent of demolishing existing structures and constructing new buildings for branch banks. In some instances, an Agent may attempt to disallow a demolition loss, even where a building has been used for many years. In one case, an Agent is proposing to disallow demolition and obsolescence losses on buildings used by a bank more than forty years.

Originally there were two banks located side by side. In 1957, the banks merged, and it was decided to demolish the existing buildings and construct new quarters on the same site. This was to be done in two separate stages. Depreciation on the existing buildings was accelerated on account of obsolescence.

The bank considered it bad practice to have a large part of its capital, permanent surplus, and undivided profits invested in its banking house. Therefore, it was decided to form a subsidiary to construct the new building. Old buildings were to be demolished by the bank, after which land was sold to the subsidiary. Effective June 30, 1960, the bank merged with another bank and filed a final tax return. An obsolescence loss and a demolition loss for the first stage of the building program had been claimed and allowed for the years 1958 and 1959; however, the Agent proposes to disallow the obsolescence claim since that time, as well as the demolition cost of the second stage of the construction program.

The Agent explained the disallowance as follows:

Effective January 1, 1958, the taxpayer accelerated the write-off of buildings to reflect depreciation and obsolescence over a remaining life of four years. This action was based on the taxpayer's determination either to move or to demolish the structure located on said land and to construct a modern office building and combination banking houses thereon adequate for its future contemplated needs.

In 1959 the taxpayer organized a wholly owned subsidiary for the purpose of constructing and/or holding title to the new building in its own right. As of December 31, 1959, the subsidiary had title and possession of the building plans, including all the benefits and liabilities of ownership, had entered into a contract with a local joint-venture to construct the proposed building, had secured financial assistance and term mortgage money to construct the building, and had received title to a part of the real property (from the taxpayer) upon which the building was to be constructed. In addition, the former buildings on the real property received from this taxpayer had been demolished and the building project was under way.

Inasmuch as the taxpayer had divested itself of the real property by option to the subsidiary, it is held that obsolescence is not an allowable ordinary and necessary current operating expense in this instant case, but that the adjusted basis at January 1, 1960, less allowance for normal depreciation, is recoverable only in determining gain or loss realized from the sale of the property to the subsidiary.

A similar explanation was given for the disallowance of the cost of demolishing the building.